Client's Corner

Don't Interrupt the Compounding

"You make most of your money in a bear market; you just don't realize it at the time."
—Shelby Cullom Davis

THE EARNINGS OF THE S&P 500 FOR THE FULL YEAR 1971 WERE $5.57; the cash dividend that year was $3.16. The Index itself ended the year at 102.

The current consensus earnings estimate for this year is a little over $190. The dividend appears to be on track to finish the year at or around $60. As I write, shortly after the equity market had a two-day panic attack over the dreaded Delta variant, the Index is at 4,300.

To summarize: since year-end 1971, the earnings of the S&P 500 are up about 34 times; the dividend is running at an annualized rate close to 19 times higher. The Index itself is up a little over 40 times, propelled—as it's always been over long time horizons—by the rising earnings.

(You didn't ask, but the Consumer Price Index, which was 41.1 in December 1971, stood at 271.1 this past June, the last month for which the figure is available. It is thus up about 6.6 times. Permit me to repeat: S&P 500 up more than 40 times, cost of living up less than seven times. This is the quintessence of why you own equities in the first place. But I digress.)

What did one have to do, in the 50 years since 1971, to participate fully in that growth? Just three things, really: one had to (1) reinvest the dividends as soon as they were paid, (2) pay taxes on the dividends and any other interim gains from another source, and (3) most important of all, ***never interrupt the compounding.***

Now, you may ask, what on earth does the phrase ***never interrupt the compounding*** mean? It means, quite simply, that one had to remain invested in the S&P 500 every day. Very few people could have done that.

You see, between January 1973 and October 1974, the S&P 500 Index declined approximately 48%. Between March 2000 and October 2002, it went down about 49%. Then, between October 2007 and March 2009, it declined 57%. (For the record, these were the largest declines since the 1930s.) A great many investors—perhaps most, although I'd have no way of demonstrating this—got taken out by one or another of these cataclysmic (but ultimately fleeting) bear markets.

Perhaps when the market turned around, recovered its old high, and then advanced far into new high ground—as it always has—many of these investors realized the error of their ways, and bought their portfolios back at significantly higher prices.

But they missed those glorious months (and even years) when their reinvested dividends could have been running around buying up large numbers of panic-priced shares—after which, in every case, the market shot higher. And having missed those pivotal episodes, investors found thereafter that they could never catch up.

Thus we see that the most important prerequisite to achieving the wealth in equities referenced above was simply not to get out of the market. Let me rephrase that, albeit a bit more pointedly: ***not to panic out of the market***. (It remains very difficult to understand why, when the shares of great businesses go on sale, everyone runs out of the store. But again, I digress.)

It's just that bromides like ***think long term*** and ***don't panic*** can seem so vapid when you're watching a third of your retirement nest egg appearing to disappear—as it has, on average, one year in five or six since the end of the Second World War. So, in quiet desperation, I've fallen back on ***don't interrupt the compounding***.

How much more heartbreakingly true must this be of people who are accumulating equities gradually, one paycheck at a time—as I did, as most people do—yet who stop investing out of fear at or near historic market bottoms, which are the ideal buying opportunity. I've personally never gone through a bear market during which someone didn't ask me, "Should I stop funding my 401(k)?" (It happened again in March 2020. I can tell you where I was standing.)

The essence of lastingly successful equity investing is very long-term compounding. Done right, it should be akin to watching paint dry. It isn't intellectual/analytical at all; it's overwhelmingly temperamental. It's about faith, patience and discipline. (Am I starting to sound like your financial advisor?)

It is, finally, about ***not interrupting the compounding.***

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(Sources: S&P 500 earnings, dividends and levels: "S&P 500 Earnings History," NYU Stern School of Business; 2021 earnings estimate: Yardeni Research; 2021 dividend estimate: Bloomberg, YCharts; history of bear markets: Yardeni Research; CPI: U.S. Bureau of Labor Statistics, inflationdata.com)